Mining & Metals Industry

American Coal Council
Sarbanes-Oxley Compliance Initiative

July 19, 2005

St. Louis, Missouri

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Overview – Sarbanes Oxley Act Section 404

Overview of Sarbanes-Oxley

- Creates new financial reporting requirements for issuers
- Creates new criminal laws relating to corporate conduct
- Creates a new Public Company Accounting Oversight Board (PCAOB)
- Mandates corporate governance reforms
- Enhances the role and independence of audit committees
- Creates new auditor independence restrictions

Responsibilities Under §404

- Sarbanes-Oxley §404(a)(1) and (2): State management's responsibility and assessment of the effectiveness of internal controls in annual report
- Sarbanes-Oxley §404(b): Auditors attest to management's assessment in annual report

Implications of §404

- PCAOB adopts Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements

New Definition of Public Company Audit

- Integrated activity that consists of:
  - An audit of the financial statements
  - An audit of internal control

Audit of financial statements	Audit of internal controls
Refers to procedures we perform to audit and issue our opinion on the client's financial statements	Refers to an opinion on the client's assessment of internal control and on the effectiveness of internal control

Key Implications and Trends

- Additive to the core assurance work
- Executive management has heightened its overall awareness and involvement in the design, implementation, and monitoring of internal controls over financial reporting
- More attention to polices and procedures and related controls over highly subjective accounting areas
- Companies are involving their auditors on a timely basis to make sure there is agreement about the scope of the annual assessment, including significant accounts and processes
- Audit committees are requesting periodic status briefings from management

Internal Control – Integrated Audit Focus

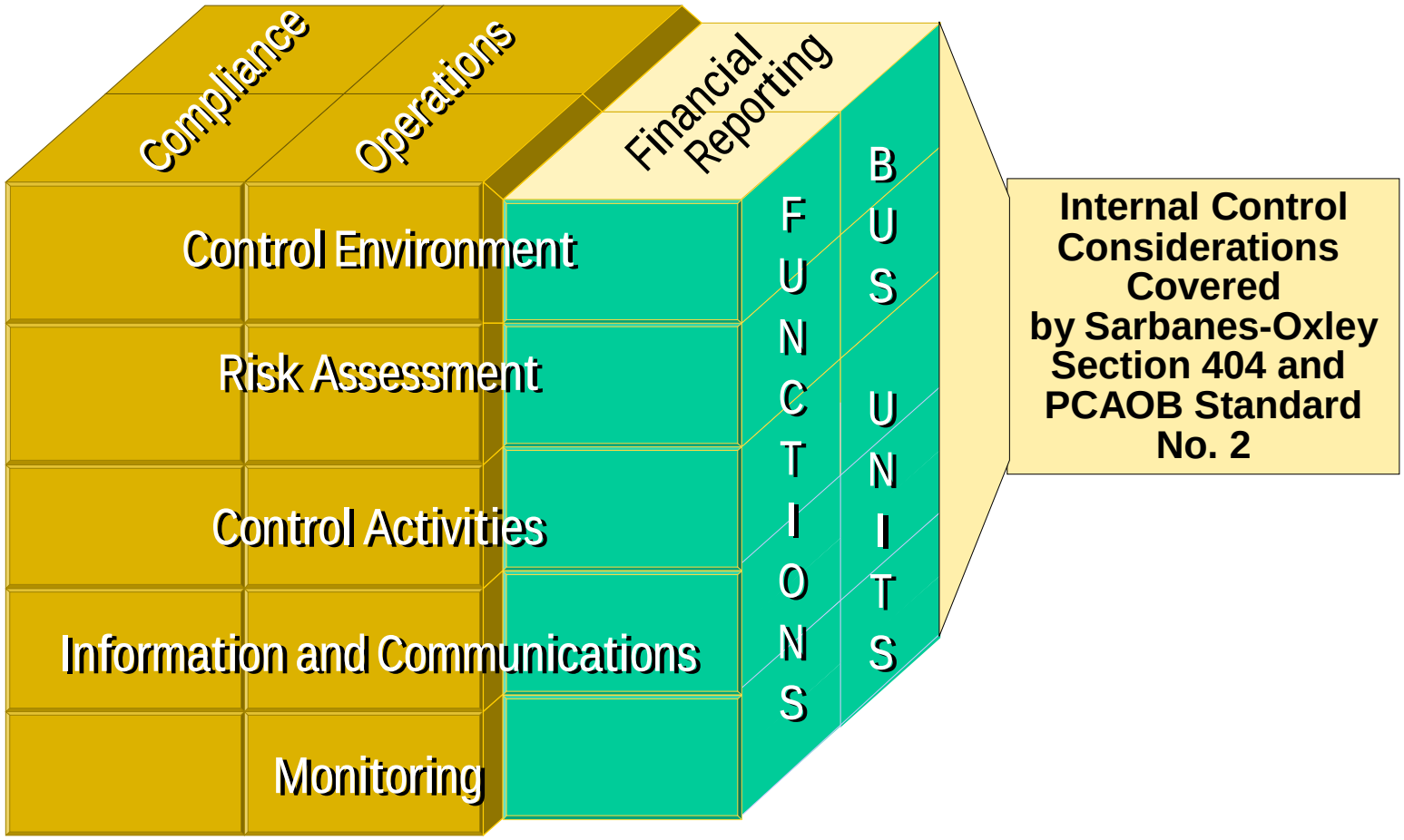


Diagram Based Upon AICPA Auditing Standards AU319, Definition of Internal Control (Paragraph .13)

Materiality Considerations for §404

Definition of materiality:

Errors that individually or collectively could have a material effect on the financial statements, or other matters such as illegal acts, conflicts of interest, and unauthorized management perquisites that, even though they are not material, could adversely affect the Company's reputation or its relationship with its customers, shareholders, or the public if they were to remain undetected.

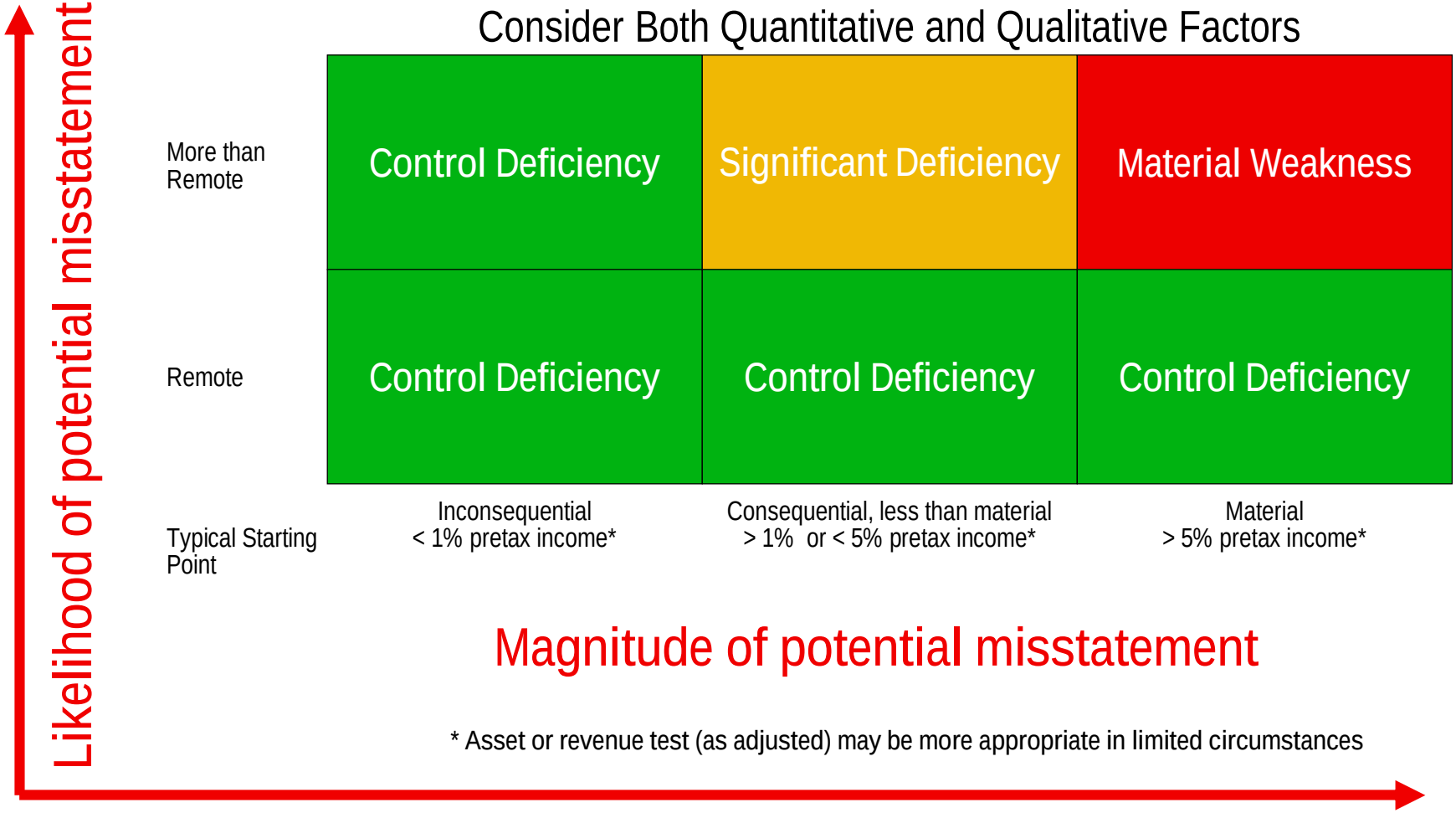
Key considerations:

- Quantitatively, 5% of pre-tax income is a generally accepted standard for considering financial statement materiality.
- In addition to the above, certain qualitative considerations impact the selection of accounts for review:
  - - Other accounts that could adversely impact the Company's reputation, even though they are not material in terms of size
  - - Other accounts that are susceptible to fraud
  - - Other accounts aggregating more than the established materiality level that are an accumulation from more than one site

Materiality Considerations for §404 (cont.)

- Internal control deficiency:
  - Design deficiency exists when a necessary control is missing or an existing control is not properly designed
  - Operating deficiency exists when a properly designed control is either not operating as designed or the person performing the control does not possess the necessary authority or qualifications to perform the control effectively
- Significant deficiency is an internal control deficiency that:
  - Could adversely affect the entity's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements
  - Must be reported to the Audit Committee
  - Not necessarily a reason for a qualified attestation report
- Material weakness is a significant deficiency in one or more of the internal control components that:
  - Alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level of risk that material misstatements in the financial statements will not be prevented or detected on a timely basis
  - Must be disclosed in management's public report on internal controls
  - Results in a qualified attestation report

Classifying Control Deficiencies



* Asset or revenue test (as adjusted) may be more appropriate in limited circumstances

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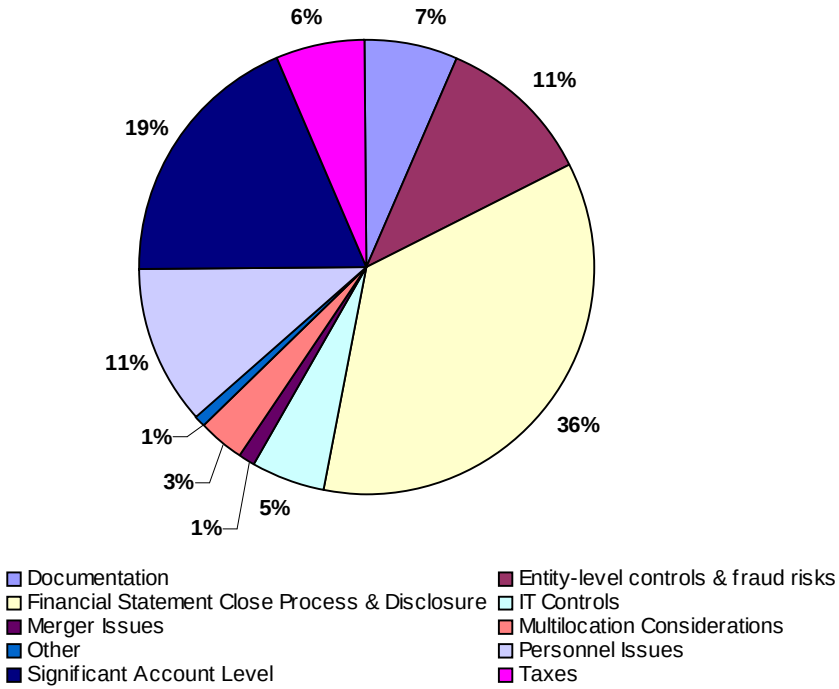
Sarbanes Oxley Section 404 Post-mortem on Year 1

Sarbanes Oxley Section 404

- Summary results reported through April 29
  - See detail through May 20,2005
- Implementation recap
- Material weaknesses reported and significant deficiencies (anecdotal) in the mining industry
- Recent developments from the SEC and PCAOB

Summary –Material Weaknesses by Major Category

10-K Filings Through April 29, 2005



Material Weaknesses By Major Category	Material Weaknesses by Type (Ames)	#
Documentation	Policies/documentation issues	79
Entity-level controls & fraud risks	Controls environment	115
	Compliance monitoring	13
	Anti-Fraud controls	8
Financial Statement Close Process & Disclosure	Application of GAAP/accounting policies	162
	Review of transactions	137
	Financial statement closing processes & consolidation	60
	Intercompany accounts/reconciliation	61
IT Controls	IT & applications infrastructure	13
	IT & applications security/user access	29
	IT & applications change controls	10
	IT & applications data protection	10
Merger Issues	Merger/Predecessor Issues	14
Multilocation Considerations	International operations & subsidiaries	39
Other	Other	11
Personnel Issues	Staffing Issues (levels, expertise, training)	99
	Segregation of duties	37
Significant Account Level	Revenue & billing	38
	Property, equipment, leases	57
	Inventory management	32
	Contracts/loan/third-party transactions	43
	Employees benefits/pensions	24
	Accounts receivable	13
	Accounts payable	6
	Accruals/restructuring costs	16
Taxes	Tax issues	76

404 Implementation Recap

- Executive buy-in and “tone at top” was a key success factor
- First year implementation was “brute force” and heroic efforts
- Lack of history and evolving interpretations (or late breaking interpretations) created inefficiencies

404 Implementation Recap

- Documentation efforts were greater than initially anticipated; many companies did not have detailed policies or procedures to leverage
- Companies used a combination of flow charts, narratives and risk and control matrices as core documentation
- Some companies outsourced documentation, then had a “change management” issue to get process owners to own it
- We saw cases of both over- or under-documentation; difficulties deciding where 404 began and ended and delineating compliance controls vs. financial controls
- Documentation was not always consistent between business units creating inefficiencies and, in some cases, risks (i.e., control gaps)

404 Implementation Recap

- Testing performed by internal audit, other internal resources and outside resources
- Some testers tested processes and not controls
- Some controls were not thoroughly tested (i.e., some attributes of a set of controls were missed)
- Most testing was performed late in the year, especially third and fourth quarters

404 Implementation Recap

Remediation Issues
Monitoring Process

- Those who did “pilots” or “dry run” testing in 2003 had fewer deficiencies to remediate in 2004
- Aggregation of deficiencies resulted in some last minute surprises (i.e., aggregated to significant deficiency or material weakness)
- Remediation efforts and related retesting is taking significant time

Mining Industry Material Weaknesses– Review of 10K Filings through May 20,2005

- Analyzed 129 mining, metals and chemical sector registrants filing 10Ks through May 20, 2005
  - Twenty-two (22) of those reported material weaknesses
- Primary areas noting material weaknesses
  - Tax issues (greatest number; deferred taxes, quarterly rate determination)
  - Financial statement close processes
  - Inventory management (spare parts and supplies)
  - Staffing issues – levels, expertise & training

Mining Significant Deficiencies– Anecdotal from our Client Base

- Untimely reconciliations between fixed asset system and general ledger, including untimely follow-up of reconciling items, as well as untimely review of work-in-process accounts, leading to misstatement of depreciation expense
- Lack of periodic review of user access to applications, leading to conflicts of segregation of duties
- Quarterly perspective, material misstatements in supplies expense due to a physical inventory being performed only in the fourth quarter
- Proper recording of discrete event in proper quarter
- Tax basis balance sheet errors – deferred income tax analysis

Framework Design Objectives for 2005

404 Sustainability

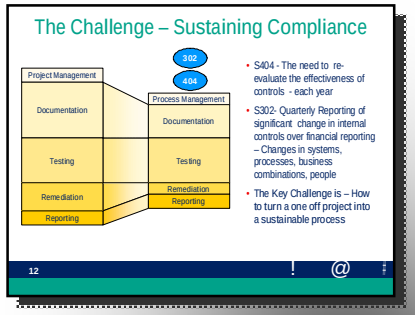
The processes, resources, organizational structures, tools and enablers required to comply with the ongoing requirements for reporting on the effectiveness of internal controls over financial reporting.

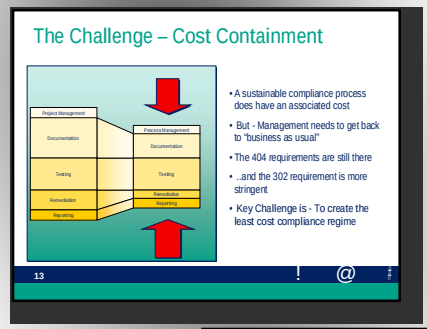
Cost Containment

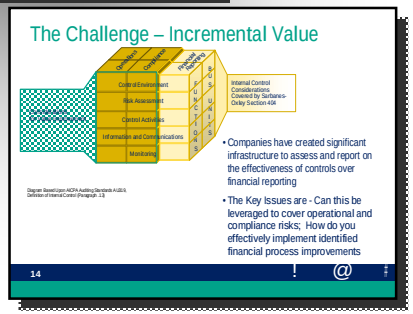
Leading practices, techniques and enablers to help build and operate the most cost- effective compliance process.

Value Generation

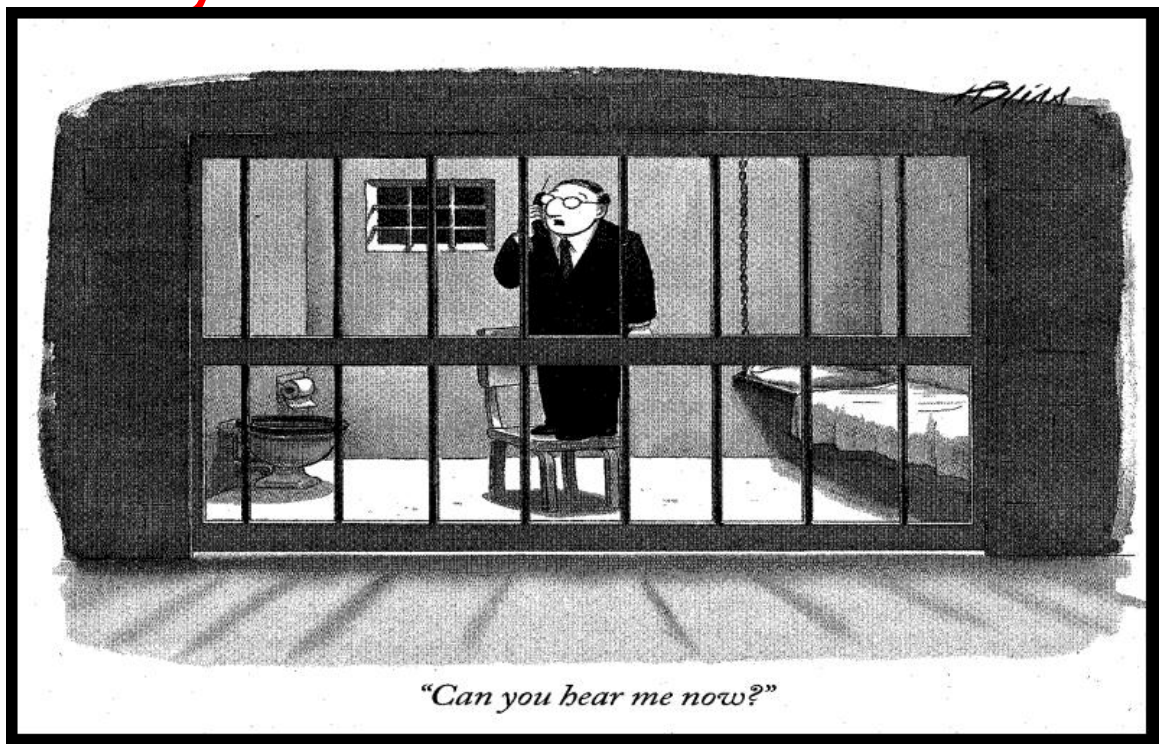
Ideas and strategies for recovering tangible value by leveraging 404 infrastructure across other risk areas, achieving control optimization, as well as business and financial process improvements.







The new reality



The New Yorker
- October 21, 2002

The New Reality - Significant Penalties

- False certification subjects person to a fine and/or prison
- Knowing violation: $1 million / 10 years
- Willful violation: $5 million / 20 years

Other Observations

- Accept that the financial reporting environment has changed profoundly—more effort, more accountability
- 404 is a process, not an event
- Each company has unique circumstances to address
- Management should include 404 implementation and on-going compliance costs in budgets
- External resources to assist may become strained
- There is no “silver bullet”
- Understand the limits of internal controls—mitigation, not elimination, of risks

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Section 404 – Recent Developments

Review of New Guidance Issued by the SEC and PCAOB

SEC Statement

- Reasonable assurance (i.e., a high level of assurance), but more flexibility in getting there
- Top down, risk-based approach
  - Avoid giving all significant accounts equal attention without regard to risk
  - Qualitative factors should also be considered in the determination of whether or not an account is significant
- Material weakness does not necessarily exist in every case of restatement resulting from error
- Management discussion of accounting and auditing issues with their auditors is not of itself indicative of a deficiency
- No expectation for testing IT general controls that do not pertain to financial reporting
- Will continue to assess effect of reporting on internal control to smaller public companies and foreign private issuers

Ernst & Young Observations—SEC Statement

- Issuance of SEC staff guidance is positive and should contribute to a better dialogue between management, audit committees, and auditors
- Issuers should achieve improvements in the second year's process by refining their approach in areas of lower risk
- The SEC staff has not prescribed the required scope of management's assessment
- Necessary evidence to support management's opinion must be commensurate with the "high level of assurance" that reasonable assurance requires

Ernst & Young Observations—SEC Statement (Cont.)

- Robust and well-documented management assessment will present the auditor with the opportunity for greater reliance on the work of management with a commensurate reduction in the auditor's own work
- SEC staff states that dialogue and consultations between management and the auditors continue to be appropriate
- Every restatement is not a material weakness, but auditors still must follow AS2 paragraph 140
  - Restatement indicates at least a significant deficiency, and a strong indicator of material weakness, if the deficiency is not remediated before year-end

PCAOB Policy Statement—Significant Themes

- Integrate the audits
- Exercise professional judgment
- Top-down, risk-based approach
- Flexibility in using the work of others
- Auditor's ability to provide advice to clients

Ernst & Young Observations—PCAOB Policy Statement

- We are pleased that the positions and views expressed by the PCAOB in its policy statement and series of questions and answers are consistent with our approach for conducting the integrated audit
- We will continue to study the PCAOB guidance, learn from PCAOB inspection results, and engage in dialogue with our clients and others -- and will adopt changes or make clarifications to our methodology where necessary to enhance the effectiveness and efficiency of our audits

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PCAOB Questions and Answers

Top Down Approach

- Intended as a roadmap to traverse AS2
- Start with company-level controls and then drive down to significant accounts, significant processes, and finally, individual controls at the process, transaction, or application levels
- Identify, understand, and evaluate the design of company-level controls first because of their pervasive effect

Ernst & Young Observations—Entity-Level Controls

- Top-down approach is consistent with our audit methodology—however, prioritize the integrated audit effort on entity-level controls early in the cycle
- Clarification—Auditor may limit the testing of the operating effectiveness of entity-level controls to the control environment, anti-fraud programs and controls, and those other entity-level controls that have a pervasive effect on the auditor's testing of controls at the process, transaction, or application level

Risk-Based Approach

- Risk assessment underlies the entire process and has a pervasive effect on the amount of work we perform
- Consistent with the responsibility to plan the audit of internal control so that the risk of failing to identify a material weakness is low
- Risk assessment affects:
  - Identification of significant accounts and relevant assertions (Questions 41 and 42)
  - Nature, timing and extent of the tests of controls (Question 43)
  - Use of the work of others (Question 54)

Identification of Significant Accounts

- Quantitative measures alone are not determinative of whether an account should be identified as significant
- The auditor should design control testing strategy to be responsive to his or her assessment of the risk related to the account

Effect on E&Y Strategy—Significant Accounts

- We believe accounts that are quantitatively material are significant accounts
  - If an account is deemed significant, it is significant for both the audit of the financial statements and the audit of internal control over financial reporting
- Lower risk should be reflected in the nature, timing, and extent of the procedures applied by management and auditors (i.e., risk-based approach)
  - Focus on those components of the account or the relevant assertions that pose the risks
- Auditor still needs to conclude that controls over such accounts are operating effectively
  - Eliminating internal control testing and performing more substantive financial statement audit procedures is inconsistent with the integrated audit

Identification of Significant Controls

- Management may identify and test more controls than necessary for the purpose of its assessment of internal control over financial reporting
- Auditor needs to walk-through and test only those controls that are critical to achieving the relevant assertions related to significant accounts
- Our methodology for the integrated audit requires that we test only those controls that are critical to achieving the relevant assertions related to significant accounts

Risk Assessment Effect on Nature, Timing and Extent of Testing

- As the risk associated with the control decreases, the persuasiveness of the evidence that the auditor needs to obtain decreases
- Auditor has significant latitude to determine what work should be done
- Strong, pervasive company-level controls can influence testing of other controls

Effect on E&Y Strategy—Nature, Timing and Extent of Testing of Controls

- Our methodology considers a number of factors in determining the extent of testing, including:
  - Degree that management plans to rely on the control
  - The relative importance of possible errors that could result
  - Strength of entity level controls
- Strong entity level controls also can affect:
  - Number of and approach for locations that are individually insignificant but significant in the aggregate
  - Rollforward procedures (PCAOB Question 51)

Using the Work of Others

- Reliance on the work of others should be responsive to the degree of risk associated with the testing of the area
- The evaluation of whether or not we have obtained principal evidence should be primarily **qualitative**
- The auditor should perform work in areas that represent higher risk and ascribe more weight to the work performed in those areas

Effect on E&Y Strategy—Using the Work of Others

- We continue to clarify our internal guidance to emphasize the qualitative nature of assessment
  - Judgment is critical
  - We should be able to rely to the greatest extent on highly competent and objective internal auditors
- Opportunities to realize efficiencies should occur as—
  - Management continues to refine its approach and processes for testing internal controls
  - Those performing the testing become more proficient through experience
- Ability to use the results of self-assessment processes will depend on the nature of the process and other factors

Benchmarking Controls

- Benchmarking strategy for testing automated application controls can be used
- Our methodology for conducting an audit of financial statements outlines guidance for benchmarking application controls where companies have made investments in effective IT general controls

Alternating Tests of Controls

- This is not rotation of controls
- The auditor may vary the use of the work of others, time period over which controls are tested, the number and types of procedures performed, or the combination of procedures used in a particular area, from year to year
- *We agree that it is appropriate to alter the nature, timing, and extent of our tests however, it is important to point out that each year the auditor must obtain sufficient evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements*

Management's Reliance on Monitoring and Self Assessment

- Management's interaction with the system of internal control provides them with a broader array of procedures by which to evaluate operating effectiveness
- We have always recognized and advocated the view that management has a number of "tools" at its disposal for monitoring or evaluating their system of internal control over financial reporting, and we will continue to do so
- We will continue to consider these procedures when evaluating management's assessment and determining the extent to which we can use the results of such procedures in our audits

Management's Reliance on Monitoring and Self-Assessment (cont.)

- Clarifies AS2 definition of self-assessment to narrow meaning—an assessment made by the same personnel who are responsible for performing the control
- Determining factor is the objectivity of those performing the assessments
- We will continue to evaluate the competence and objectivity of the person(s) performing self-assessments as a key factor for determining whether and how to use the work of others

Extent of Management's Testing

- The auditor need not evaluate the adequacy of management's assessment by comparing, on a control-by-control level, whether management's testing was at least as extensive as their own
- Management's testing should be sufficient to support their conclusion (i.e., assertion about the effectiveness of internal controls) but does not need to be approached in the same manner as the auditor

Point in Time Assessment

- Auditor should structure testing of controls to obtain sufficient evidence to support the opinion on internal control over financial reporting and to obtain sufficient evidence to support a control risk assessment of minimum for purposes of the audit of financial statements
- Accordingly, the auditor tests controls over a period of time
- Consistent with E&Y Guidance

Various Topics

- Question 52—It is inappropriate for the auditor to conclude that management should not implement changes to IT systems for some arbitrary period of time before year-end
- Question 53—A control is not ineffective solely because there is no documentation evidencing the operation of the control
  - PCAOB— “the auditor must be satisfied however that the control actually operated”

Summary

- Identify and evaluate entity-level controls early in the audit so that our audit strategy might incorporate the benefit of strong entity-level controls
- Lower risk should be reflected in the nature, timing, and extent of the procedures applied by management and auditors (i.e., risk-based approach)
- Opportunities to realize efficiencies by using the work of others should occur as management continues to refine its approach and those performing the testing become more proficient through experience
- Continue to evaluate the competence and objectivity of the person(s) performing testing (including self-assessments) as a key factor for determining whether and how to expand the use of the work of others